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No. 90-1905

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IN THE

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1990

JAMES B. MARINE AND VERA L. MARINE,
PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR WRIT OF CERTIORARI TO
THE UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

REPLY TO RESPONDENT'S BRIEF IN OPPOSITION TO PETITION FOR WRIT OF CERTIORARI

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DISCUSSION OF THE BRIEF FOR RESPONDENT (herein "R Brief") WHICH OPPOSES THE PETITION FOR CERTIORARI (herein "C Petn")

R Brief stiffly defends the IRS position which is so faithfully reproduced in the Tax Court's opinion below and selectively affirmed by the Ninth Circuit; it admits of no error or injustice

1. This case is concerned with losses of limited partners who invested in partnerships to acquire US-leased Post Offices, only to later discover that they had been defrauded by general partner Schulman; he had pretended to use their cash to pay partnership interest expense, but in fact took it for his own use in his concealed operation of buying such Post Offices and reselling them to his partnerships at large mark-up and profit

to himself. To deny to these victims deduction for their cash losses in the years when sustained and known, is a grave injustice; especially so when it is remembered that the thief, himself, advised them to take deduction in those years, but for a falsified reason; and that to postpone deduction during multi-year pendency of their tax case, during which the theft cause was discovered, will multiply the tax deficiency nearly four times because of accrual of non-deductible interest meanwhile. As if that result wasn't sufficiently unjust, penalties were added.

We believe C Petn demonstrates that this injustice was not sanctioned by the tax statutes; quite the reverse.

R Brief repeats the Tax Court's statement that our taxpayers were not embezzlement victims because they got what they bargained for: ownership of Post

Offices with excessive claims to tax deductions. Obviously they didn't bargain for being defrauded. R Brief and Tax Court are really saying that these people invested with a primary tax motive, therefore must be denied the statutory deduction for theft loss.

Before Schulman's fraud was discovered the deductions claimed by investing limited partners were deemed proper in the 1983 IRS settlement agreement, except for 30% disallowance of the supposed initial "interest" deductions. IRS withdrew from that agreement when it subsequently learned of Schulman's fraud ---- elaborate offshore money movements falsely pretending interest payments so that he could use the cash in his concealed operation of buying properties and reselling them to his partnerships at enormous profit to himself. C Petn pp. 9 et seq.. Only then

--- i.e. upon discovery of his fraud on his investors--did IRS begin to treat the investors' deduction claims as so excessive as to indicate primary tax motivation.

IRC Sec.165(e) authorizes deduction for theft loss without reference to the victim's investment motives. Neither R Brief nor Tax Court opinion refers to this statutory absolute. For IRS to deny theft loss deduction, by writing a tax motivation condition into this statute, was an abuse of power; was, in fact, an over-reach of its great anti-tax-shelter crusade described at pp. 22 et seq. of C Petn (no comment by R Brief). For the Tax Court to approve such statutory modification was a departure from proper judicial proceedings.

The Ninth Circuit's decision, approved by R Brief, to postpone theft loss deduction until knowledge of theft

and loss coexist, distorts the clear meaning of Sec.165(e). In business accounting a loss, or a profit reduction, often is sustained and known without knowing that the true cause was dishonesty of an employee or manager who falsified income, expenses, inventories or other records. Under Sec.165(a) deduction is allowed when the loss is sustained. Sec.165(e) was added by Congress to help the theft victim who was unaware of his loss when it occurred, an example being stolen jewelry which is not missed for several years. When that subsection, and the committee report and regulations interpreting it, speak of deduction when "such loss" is discovered, they are supporting the Sec.165 concept of allowing deduction when needed ---- i.e. when a loss is known to have been sustained.

The Ninth Circuit position really rewords the statute to allow deduction when the "theft" is discovered, since in the usual case, if theft and loss are not discovered simultaneously, the loss will have already have been sustained and known when the theft-cause is discovered. Two courts have stated that subsection (e) refers to the discovery of the "loss", not of the "theft" (C Petn p.29); which it obviously does.

Rather than help theft victims, as Congress intended, the Ninth Circuit position would hurt them; a business corporation or person deceived by a thieving manager, as were the victims here, would lose deduction for a known and sustained loss (but not for a reduction of income) if, while the loss year was open in audit or court, the deceit was discovered. Even if the theft-discovery year could be established and the second

deduction effort sustained, the non-deductible interest for the intervening period could ruinously multiply the tax deficiency for the loss year (it would for our taxpayers).

This is the first case to clearly present the question whether Sec.165(e) was intended to and does require postponement of deduction for a known and sustained loss if a theft cause is later discovered ---- a delay most likely caused by deception of the thief, as it was here. The clear statutory words and intent to help theft victims should not be distorted to require such postponement.

R Brief observes that the facts before the Ninth Circuit in Rod Warren Ink, 912 F2d 325, were not identical to those here. Nevertheless its decision there to interpret Sec.165(e) so as to help a theft victim conflicts with its

interpretation here which is seriously harmful to theft victims.

2. R Brief, like the Ninth Circuit, states that the transactions here had no economic substance, without explaining how that can be. The partnerships here did own U.S.-leased Post Offices, did collect annual rent sufficient to carry the properties and pay principal and interest installments on the acquisition mortgages; those mortgages were effectively validated by the civil suit settlements with Schulman et al. (C Petn pp. 36 et seq.) and were treated by IRS as valid for all 600 of Schulman's partnerships, except for those partners who litigated their right to theft loss deduction (the IRS settlements allowed depreciation and interest deductions but required giving up cash loss deductions).

R Brief fails to comment on the historical approach of IRS to tax shelters

discussed in C Petn, pp. 21 et seq.; in particular, fails to discuss the Congressional purpose, recognized by the Treasury, to sanction real estate tax shelters during the years at issue here. When our taxpayers invested in Schulman partnerships the tax law specifically authorized the tax benefit of depreciation deductions, based on non-recourse partnership debt, useful against income from other sources.

If the substantial cash investment of our taxpayers is disregarded, because it was expropriated by Schulman, nevertheless the mortgage debt properly supported the depreciation deductions they were instructed (by Schulman) to and did take (the interest deductions were paid from cash rents). Of course this Congressionally authorized benefit has its offsetting detriment. Our taxpayers will realize taxable income, geared to the

outstanding mortgage debt and basis reduced by depreciation, when the property is disposed of or abandoned; which taxable income was overlooked by the Tax Court, and R Brief, in their conclusions that profit was impossible for our taxpayers. It is also true that they have relied upon, and slanted to their own purpose, the lease provisions and other facts unknown to our taxpayers when they invested. C Petn pp. 37 et seq..

The IRS-Tax Court's complete disregard of the partnerships' mortgage debt, because it was non-recourse and allegedly exceeded the property's fair market value, is an administrative and judicial construct without statutory support; it is part of the great IRS crusade against tax shelters. As we have noted, and as IRS has recognized in its thousands of settlements with Schulman investors, the mortgage debt here had

substance, was not purely formal. There is no support in statute or reason for altogether disregarding it because it exceeded "fair market value" as testified to by an IRS expert witness. True, Schulman charged his partnerships much more than he had paid for the same properties, but his investors did not know that at the time.

Although this Court's decision in John Tufts, 461 US 300, dealt with the disposition end of a real estate transaction, its rationale was that non-recourse debt is to be regarded at acquisition and disposition alike, even though it exceeds fair market value; which was the IRS position at that time. The decisions below, and the present IRS position, are clearly in conflict with Tufts and with the IRS position when our taxpayers invested.

And, of course, the R Brief-IRS stand that if any such excess exists (as determined by IRS and ex-post-facto appraisals), the debt can be entirely disregarded, seems palpably outrageous; such conflicts with the Third Circuit's decision in Pleasant Summit Land Corp, 863 F2d 263, that such debt must be regarded up to fair market value of the underlying property. However we reiterate our position that the mortgage debt here is valid and should be fully sustained.

3. R Brief's argument for sustaining all penalties is answered at C Petn pp. 42 et seq. However one further comment is in order: the 1983 settlement agreed to by IRS imposed no penalties on Schulman investors; such were imposed only after IRS discovered Schulman's fraud; which penalizes them taxwise for the fraud committed upon them.

CONCLUSION

This Court is pre-occupied with issues of nationwide importance, has little time for tax issues. Although the decisions below conflict with decisions of this Court and Circuit Courts of Appeal, this Court might be reluctant to allocate its time for review of this case, however deserving it may be from the standpoint of law and justice. Nevertheless there is an important reason why it should do so.

There is a tendency of IRS, exemplified by this case, to sometimes overextend its powers in such manner as to distort the law and injure taxpayers contrary to Congressional intent. There is also a tendency of the Tax Court, which is repeatedly bombarded by an IRS contention, to approve that contention, as it has done here. Circuit Courts of Appeal, busy with non-tax cases, are sometimes inclined to affirm the Tax Court

and IRS without careful analysis, as the Ninth Circuit has done here.

Where, as here, there are a number of taxpayers affected by an IRS position, it is very difficult for them to organize and pay for an opposition. In this case, such opposition was frustrated by the defrauder's hiring and paying for his own tax counsel to represent investors, which counsel persuaded most of them to settle with IRS by surrendering their cash loss deductions, without telling them of the fraud upon them by said counsel' other client. It was only the chance that a few non-settling investors found an attorney, sufficiently interested in their cause to represent them without adequate compensation, that the important issues of this case have reached the courts at all.

We respectfully submit that this Court should use the rare example of this

case: to remind IRS to act within the scope of its authority, which does not include making law administratively; and to remind the lower courts to examine IRS positions with greater care. The Petition for Certiorari should be granted.

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